

STOCK OPTIONS AND OTHER EQUITY-BASED COMPENSATION

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I. Executive Summary

Early-stage companies frequently issue stock options to founders and early investors. For cash-strapped early-stage businesses, especially in the technology sectors, stock options and other equity-based compensation such as stock grant plans have long been a way to hire employee or consultant talent that they could not afford with a cash salary. Also, both early stage and mature U.S. businesses and inbound non-U.S. businesses with U.S. subsidiaries use stock option and other compensatory benefit plans to secure employee talent that they want to retain with vesting schedules and other incentivizing provisions.

The U.S. Securities Act of 1933 (the “Securities Act”) governs the issuance of securities, and, pursuant to its section 5, requires all securities issuances to be made by a public registration highly regulated by the U.S. securities regulator, the Securities and Exchange Commission (“SEC”). The first public registration of securities by a company is called an initial public offering, or “IPO.” The Securities Act provides certain exemptions from the public registration requirements, and SEC Rule 701, promulgated pursuant to section 3(b) of the Securities Act, provides an exemption from public registration for securities issued pursuant to compensatory benefit plans such as stock option, stock grant, stock appreciation, profit sharing, incentive, deferred compensation, and pension plans by most private companies, companies that have not registered their securities and which are not required to file annual, quarterly and other reports with the SEC pursuant to the Securities Exchange Act of 1934 (the “Exchange Act”), which governs the purchase and sale of securities that have already been issued pursuant to the Securities Act. There is a comprehensive review of Securities Act exemptions from registration in our “Raising Capital through Private Placements: Deal Points,” available for download with other resources at [Kurtin PLLC Raising Capital](#).

II. The Rule 701 Exemption

The Rule 701 exemption from registration of securities for stock option and related plans and grants is not available for companies required to file annual, quarterly and other reports with the SEC pursuant to sections 13 or 15(d) of the Exchange Act or companies required to register under the Investment Company Act of 1940 (the “ICA”) (however, if an issuer that has relied on the exemption to issue securities while not a reporting company thereafter becomes a reporting company, it may continue to rely on the exemption

for the securities previously issued pursuant to it; also, a reporting company may rely on the Rule 701 exemption if only guaranteeing the payment of a non-reporting company subsidiary's securities sold pursuant to Rule 701). Recipients of Rule 701 securities must be officers, directors, employees, general partners, consultants, or advisors and their family members of the issuer company who are receiving the securities pursuant to a written compensatory benefit plan such as a stock option, stock appreciation, profit sharing, incentive, deferred compensation, or pension plans, or as part of an individual written employment or consulting agreement. There are no other investor sophistication requirements. While Rule 701 may not be used for capital-raising purposes, the use of compensatory benefit plans may free up available capital for other uses.

For the Rule 701 exemption to be available, securities sold under it during the prior 12 months (measured as of the issuer company's most recent balance sheet if no older than its last fiscal year end) are limited to the greater of: (i) \$1 million; or (ii) 15% of the issuer's total assets (or issuer's parent if issuer is a wholly-owned subsidiary of parent and parent unconditionally guarantees the securities); or (iii) 15% of issuer's outstanding securities of the same class, in each case measured as of the date when the option grant is made or the sale is made, and treating any other outstanding derivative securities as outstanding. Rule 701 securities are not "integrated" with any other exempt or registered offers or sales, meaning that securities offered under any other Securities Act sections, rules, or regulations, whether exempt or not, do not count against the foregoing limits. There is no requirement to file the compensatory benefit plan or contract with the SEC. Securities issued under the Rule 701 exemption are "restricted securities" as defined in SEC Rule 144 that can only be resold if registered or with a resale exemption, including the exemption provided by Rule 701 if issuer becomes an Exchange Act reporting company after their issuance and after 90 days from issuance have passed.

The written compensatory benefit plan or contract must be provided to the investor employee. There are no specific information requirements unless more than \$10 million in securities are offered in a 12-month period, in which case certain specific disclosure information specified in the Rule must be provided, including the financial information required to be furnished by Part F/S of Form 1-A of SEC Regulation A (another Securities Act exemption) and the information required by the Employee Retirement Income Security Act of 1974 ("ERISA"), if applicable. Nevertheless, as always, the anti-fraud provisions of the securities laws and regulations apply.

The limited applicability of Rule 701 is expressly adapted for executive and employee securities-based compensation. Because the restricted securities become available for resale only 90 days after the issuer becomes an Exchange Act reporting company or the resale restriction is otherwise removed, the Rule 701

exemption is ideal for executive stock awards and stock option plans for which the issuer wishes to bind the employee to the company until it conducts an initial public offering or otherwise becomes an Exchange Act reporting company. When the exemption is combined with vesting milestones and cliffs in a stock option plan, for example, the issuer has extensive leverage to retain key employees.

III. Stock Option Basics

Calls and Puts. One of the main uses of Rule 701 is to issue exempt securities through stock option plans. The employee stock options we are discussing are technically “call” options, ones that give the option holder employee the right – the option - to purchase the issuer employer’s stock at a specified price (the “exercise” or “strike” price) within a specified time period in the expectation that the stock’s fair value price will rise after exercise of the option (less common “put” options give the holder the right to sell at a specified exercise price; a put option holder hopes and expects fair value to decline below the exercise price). Call options for which the underlying shares have risen in value above the exercise price are said to be “in the money;” options for which the fair value of the underlying shares has fallen below the exercise price are said to be “underwater” – in other words, nobody who held such an option would want to exercise it unless or until fair value rises above the exercise price.

Non-Qualified Stock Options. Employee stock options come in two varieties: non-qualified stock options (“NQOs”), and qualified, or “incentive” stock options (“ISOs”). NQOs need not be issued pursuant to an option plan, although, to take advantage of the Rule 701 exemption, the option grant must be in written form – some form of contract, often part of an employment contract. Assuming some basic compliance, NQOs constitute “deferred compensation” pursuant to U.S. Internal Revenue Code (“IRC”) §409A, and the holder of the NQOs will owe no tax on them at the time of option grant and not until the option is exercised, at which time the employee will incur an income tax liability on the spread between fair market value and the exercise price. The issuing company receives a corresponding and equal tax deduction.

Incentive Stock Options. By contrast, ISOs are required by IRC §422 to be issued pursuant to a written stock option plan that sets forth the aggregate number of shares that may be issued up to 10 years from the plan’s adoption and the employees or class of employees eligible to receive them. Only corporations may issue ISOs; limited liability companies and other entity types are not eligible. The option holder must make no disposition of the options for 2 years from the date of ISO grant or 1 year from ISO exercise, whichever is greater. The plan options must have an exercise price of at least 100% of fair market value at the time of issuance and must expire within 10 years; that is, the options issued to any employee under the ISO plan must be exercised within 10 years after grant or they will lapse. The recipient of ISOs may

not own stock representing more than 10% of the combined voting power of all classes of stock at the time of ISO issuance, unless the option price is at least 110% of the underlying stock's fair market value and is not exercisable after 5 years after grant. Only ISOs exercised by any one option holder up to a fair market value of \$100,000 are entitled to ISO tax treatment as measured by fair market value of the options' underlying stock at the time of grant; any options exercised by any individual holder above that amount will receive NQO tax treatment.

When properly structured, the ISO holder incurs no tax liability when the option is granted *or exercised*, but only upon a later resale of the shares. Assuming the stock has been held for long enough, even that tax liability will be calculated at the lower long-term capital gains, rather than higher ordinary income, tax rates. The company receives no tax deduction either on the employee's exercise or subsequent sale. For these reasons, option-issuing companies generally prefer to issue non-qualified options, while employees prefer to receive ISOs. However, given the use of options to attract and retain employees in the absence of ready cash, the ISO has become the dominant form of employee stock option grant.

Vesting Schedules and Cliffs. Vesting milestones and cliffs operate to incentivize employee option holders to remain with the issuer company even more than receiving options instead of cash would do. For example, a common model might provide that 25% of the employee's options become available for exercise each one-year anniversary after grant, so that an employee who wants to maintain the possibility of exercising all his or her the options will be incentivized not to leave the company for five years (of course, if the options are underwater and the employee believes that they will remain so for the foreseeable future, the vesting schedule provides no incentive to remain at the company). If the employee leaves the company before the first anniversary of the option grant, all the options are forfeited. ISO plans and NQO contracts typically provide that any unvested options automatically vest if the employee is terminated before the vesting period is complete, unless the termination was for cause, or in case of an M&A transaction or IPO.

Valuation and Volatility. Options are securities themselves, derivative securities whose value is derived from the value of the underlying stock that they give the option holder the right to buy or sell. As derivative securities, options are valued pursuant to several econometric models that attempt to account for the potential volatility of the underlying securities during the period before the option is exercised, the best known of which is the Black-Scholes model, a mathematically complex formula which, for an option with an exercise price equal to fair value at the time of grant, usually yields a valuation of 20 - 40% of the value of the underlying stock. In other words, options are priced, and cost the issuing company, 20 - 40% of what an equivalent stock issuance or cash payment to the employee at the same time as the option grant

would cost. Other option valuation models include so-called “Lattice” models, like the Binomial model and Trinomial tree, and the Monte Carlo model.

Rule 701 and Section 422 Interplay. Finally, note that SEC Rule 701 and IRC §422 operate independently: Rule 701 governs whether an exemption from the Securities Act public registration requirement is available. IRC §422 governs whether the tax benefits for ISOs are available. A mishandled option grant could for example, comply with Rule 701 and not §422, or vice versa. It is important for stock option plans and grants in other instruments to be drafted carefully, especially ISOs, to avoid unintended liabilities and tax consequences that the option grants were intended to avoid. For example, nothing will enrage a valued employee and cause him or her, as well as other employees, to want to leave the issuer company, than finding out that the Internal Revenue Service has disallowed the ISO tax status of the stock option grants that they accepted instead of cash and exercised, believing that the exercise would be a non-taxable event, and that they now owe income tax on the stock received even though they did not intend to sell for years, while the company is entitled to a tax deduction for having given the options to them.

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